WINE BUSINESS PERSPECTIVES

THE WINE MARKET TODAY AND AHEAD

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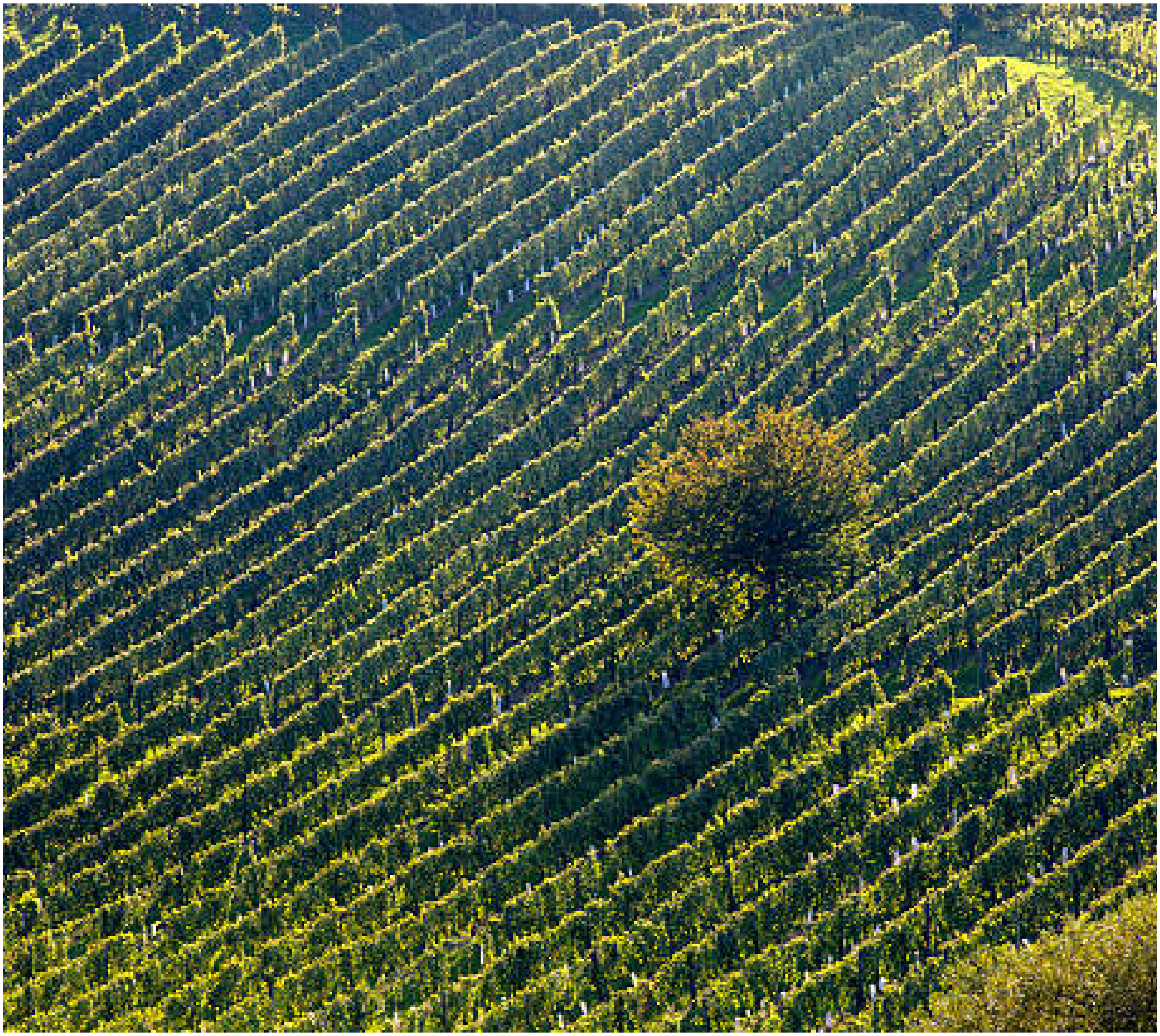

THE U.S. WINE INDUSTRY CONFRONTS AN ARRAY OF POST-PANDEMIC CHALLENGES

The flattening of U.S. demand for wine in 2017-2019, after nearly 30 years of steady growth in both the volume and value of wine sales, came as a shock to U.S. wine producers—a shock exacerbated by increased grape growing and wine production costs. Wine has always been a tough business. Now, with the recent pandemic causing a short-lived recession, and with the subsequent recovery, the economics of wine have become particularly unforgiving.

In this second installment of our three-part series exploring the history, challenges, and future prospects of the wine industry, we investigate the recent state of the market and the outlook for wine sales going forward.

U.S. WINE SALES ARE BEING RESHAPED IN THE WAKE OF DECLINE

Wine sales in the U.S. continued a multiyear decline in 2020, losing market share to spirits, even as the overall beverage alcohol market surged. The Wine and Spirit Wholesalers Association's (WSWA) SipSource reported that wine sales declined by 0.6% in first quarter 2021, with off-premises sales slowing from their 2020 levels and on-premises sales not meeting expectations.[1] Meanwhile, spirits sales accelerated nationally.

Various retail channels reported a two-tier wine sales pattern—a strong mid-price tier ($10-$25 per 750ml retail equivalent), and a much smaller and selective luxury tier ($95+ per 750ml retail equivalent). In the words of one wholesaler: "Brands between Kendall Jackson and Caymus are the ones that get hurt." This reflects a continued "premiumization," as sales in the lowest-priced segments weakened for all beverage alcohol. The slowest-growing segments in both dollars and volume were wines costing less than $10 and box wines costing less than $4.50. However, together those products still represented more than 70% of total wine sales.[2]

> "Wine sales in the U.S. continued a multiyear decline in 2020, losing market share to spirits, even as the overall beverage alcohol market surged."

The decline in wine sales during the "COVID year" (the 52 weeks ended Feb. 28, 2021) was more severe for still wine in both dollars and volume. Sparkling wines, fruit varietal wines, and wine-based seltzers were the fastest-growing subcategories, albeit from very small bases. (Although gradually losing market share, conventional still wine represented nearly 88% of the total wine category in dollars.)[3] IWSR's Drinks Market Analysis reported that: "A key driver of U.S. beverage alcohol consumption is flavor... Flavored subcategories—from beer to vodka to U.S. whiskey—are significantly outperforming traditional non-flavored subcategories."[4] The growth in spirits, packaged cocktails, and hard seltzer reflected this interest in flavor, along with convenience, portability, and low alcohol/low sugar/low calorie content.

THE ON-PREMISES MARKET SUFFERS THE MOST

The on-premises channel, particularly the full-service restaurant, was most impacted by the pandemic. An estimated 110,000 restaurants, or about one in six eating and drinking places in the U.S., including about 12% of full-service restaurants, closed temporarily or permanently.[5]

Although representing at best a 20%-22% share of three-tier wine sales, restaurants have long had an outsized role in the U.S. wine market, particularly effective at introducing new wines—especially more expensive or smaller production wines—to the American consumer.[6]

A Troubled Industry Before the Pandemic

A return to 2019 business levels may not in itself solve the restaurant industry's problems. After a reasonably healthy recovery from the Great Recession, restaurant sales and traffic began to slow dramatically, with sales growth seldom exceeding 2% p.a., though food costs were rising on average 2.5% per year, and labor costs and rents were escalating. Industry customer traffic was uneven, so that the modest sales increases depended on rising average checks. Many operators were losing money or barely surviving.[7]

In fact, 53% of restaurant food sales prior to the pandemic were consumed off-premises through take-out or delivery services,[8] the latter eating into restaurants' flattening revenues and demanding commissions as high as 30%.[9] Until the pandemic shutdowns, state alcohol regulation did not permit restaurant off-site alcohol sales, shifting beverage alcohol sales—a crucial source of restaurant profits—to retail channels.

On-premises wine sales during the pandemic declined more than the restaurant business overall. SipSource and other sources reported that total 2020 on-premises wine sales fell by more than 50% compared to 2019 levels. A SipSource report showed that wholesalers' base share for total restaurant sales in 2019 as a percentage of total wine sales had fallen to under 15% compared with 18% in previous years, describing the on-premises situation as "nothing short of catastrophic."[10]

> "On-premises wine sales during the pandemic declined more than the restaurant business overall."

The National Restaurant Association reported in May 2021 that, while 45% of operators said their sales were higher than they were in May 2019, 49% reported lower sales, and "limited-service operators… were much more likely than their full-service counterparts to report a same-store sales increase" compared to 2019.[11]

The On-Premises Outlook

Long-distance travel, especially business travel, is not expected to recover until 2024, with consequent cuts in catering expenditures and business meals that often include wine.[12] Higher-end restaurants depend heavily on business travelers, as do dining concepts located in airports and hotels. Long-distance leisure travelers may also choose short-term rentals over hotel stays, shifting beverage alcohol buying from on-premises to off-premises retail.

Trade interviews indicate that, as restaurants reopen, restocking of wine inventories has been cautious and concentrated in the mid-price segment ($10-$30 per 750ml retail equivalent), which is consistent with comments that the sweet spot for on-premises sales is about $30-$60. Restaurants, many of which sold their wine inventories to raise cash at the beginning of the pandemic, are limiting their lists to remaining inventories and the fastest-moving brands and private labels, including direct imports—tariffs and access permitting.[13]

Restructuring and reducing staff in the face of rising labor costs and a scarce workforce may demand more multiskilled and flexible workers serving multiple roles, with less specialization. There are already fewer sommeliers, with wine directors (where they remain) working on the floor to support wait staff. Producers may therefore have to assume more of the burden of wine training for remaining staff.

Restaurants are expected to reduce the number of suppliers and distributors with which they work to get better terms, resulting in volume purchases of more limited product lists—including in wine. Chains, which have increasingly nationalized their wine lists to require that any wine carried be available in all locations, may replace independent operators. That shift tends to limit access for smaller producers.

Wholesalers report that Ready-to-Drink alcohol beverages (RTDs), especially premixed cocktails, have been the strongest selling items on-premises, offering reduced complexity for a limited labor force.[14] Alcohol to-go is seen as critical to future profitability for many operators.

CONSUMERS SHIFT TO THE OFF-PREMISES MARKET

Retail food and wine channels thrived in the pandemic. Information Resources Inc. (IRI) reports that total beverage alcohol sales in the retail outlets they track increased $4.75 billion (18.8%) in the 52 weeks ended Dec. 27, 2020, compared with 2019.[15]

E-commerce

E-commerce was a relatively modest factor in food and beverage retail stores in the first quarter of 2020, representing just 1.6% of total sales, but this nearly doubled by the second quarter of 2020—to more than 3.1% of total sales, with beverage alcohol a leading beneficiary.[16] McKinsey reports that the share of consumers buying alcohol online is expected to grow from 19% of consumers before the pandemic to 34% post-pandemic.[17]

In June 2021, Nielsen reported that consumers made 10% fewer in-store trips than at the beginning of 2020,[18] and IRI noted that online shoppers are less likely to make impulse purchases (those in-store "discoveries") than other buyers.[19] They also tend to repeat past purchases, returning to familiar brands.

Specialty Retailers

Many smaller specialty shops confronted particular challenges during the pandemic. Those wine and spirits stores with an established e-commerce business reported growth that was comparable to the growth seen in grocery alcohol sales.[20] This has challenged newer, smaller wine shops located in downtowns and office centers that require foot traffic and lack a strong e-commerce and social media following.

Scaling up for e-commerce, curbside, and delivery imposes significant costs on retailers, including new technology, equipment and vehicles, new and retrained staffs, physical redesign of facilities, reductions in capacity, and repeated cleaning and sanitation. Specialty wine and spirits retailers report that scaling up all the elements of contemporary e-commerce can take 6 points off their retail margins.[21] Delivery is the most expensive element, potentially tripling the cost of e-commerce. These rising expenses encourage all such retailers to find offsetting cost savings.

In 2009, during the Great Recession, retailers cut the number of SKUs on the shelf, a practice termed "assortment rationalization," to cut operating costs and working capital needs. The same phenomenon occurred in the pandemic, with a focus on retaining the fastest-moving SKUs and high-margin private labels. A 2021 Nielsen IQ/Bain study found that, for beverage alcohol, 78% of SKUs generated less than 2% of overall sales.[22]

Off-premises Outlook

A survey that found 40% of consumers "plan to shop more at a physical store for groceries over the next twelve months" offers an optimistic sign for "discovery-driven" brands.[23] Grocery store foot traffic began to increase in April 2021, (and online grocery sales declined, while still well above 2019 levels) as consumers felt more comfortable venturing out.[24]

As import tariffs on EU wines return to previous levels, sales of imports from multiple regions are already increasing, presenting a challenge to U.S. producers. This is true whether the wines are branded, private label, or direct imports at competitive prices.

With most retailers carrying between 350 and 3,500 wine SKUs[25]—and a tiny handful having perhaps 10,000 bottles in a warehouse, having access to retail shelves will be challenging for many producers. This also comes at a time when the Alcohol and Tobacco Tax and Trade Bureau is approving more than 100,000 new wine labels per year.[26]

CHALLENGES ARISE WITHIN TRADITIONAL WINE CONSUMPTION PATTERNS

Canned Wine

Canned wine is a market that continues to grow, as winemakers discover that putting better quality and higher interest wines in cans makes economic sense. While most canned wines are priced at $15-$20 per 750ml equivalent, some canned wines are emerging at higher prices. Dollar sales in Nielsen-tracked channels "reached $253 million in the 52 weeks ended March 20, 2021, up 62% over the previous 12 months, and volume sales increased 67%, reaching the equivalent of nearly 30 million bottles."[27]

Millennials are the largest consumers of canned wine, with sales reportedly driven by portability, convenience, serving size, and environmental advantages (ease of recycling). One analyst noted that "[t]he new singles provide an on-ramp to new and younger adult customers by reducing trial cost."[28]

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Private Label

Sales of private label wines, both imported and domestic, which had grown substantially in the years after the Great Recession, initially slowed slightly with the shift to e-commerce. McKinsey's August 2020 COVID Tracking survey found that 25% of consumers had tried a new private label brand since the pandemic began. And 73% of these consumers, particularly Gen Z and those with incomes greater than $100,000 per year, intended to continue using these new brands past the pandemic.[29] Many grocers are already increasing their private label investments.

Ready-to-Drink Alcohol Beverages

Ready-to-Drink alcohol beverages (RTDs), primarily premixed cocktails and hard seltzers, have become a category of their own. The premixed cocktails category "continues to gain incredible momentum, up 73.1+ percent," with growth both on- and off-premises through first quarter 2021.[30]

- **Wine-based:** Although wine-based cocktails are still a small share of the RTD cocktail market, Nielsen reported that the wine cocktail category grew by 102% in dollar terms in the 52 weeks through March 2021 compared to the same period the year before.[31] One producer noted that wine-based RTD cocktails "provide a cocktail solution for grocery stores that are unable to sell hard liquor."[32]

- **Hard seltzer:** Hard seltzer is taking the place of beer, especially for younger consumers, and has expanded beyond the original flavored-malt-based drinks into spirit- and wine-based seltzers. IRI found that 48% of hard seltzer consumers had shifted from beer, wine, and spirits attracted by accessible pricing, novel and convenient packaging, and flavor, plus lower alcohol and calorie content.[33] The consumer demographic seems to have widened to include a more affluent, better educated, and much broader age demographic, with the product being equally acceptable to men and women.[34]

Spirits

Spirits, especially premium spirits, have taken significant market share from wine in all three-tier channels across the country for nearly every period since the pandemic began, as well as multiple quarters before. In January 2021, DISCUS claimed that wine had lost market share to spirits for the 11th consecutive year.[35] Here again, retailers reported a two-tier market: a flight to extreme quality and value on the one hand and highest priced on the other, with no middle.[36]

Beer

The formerly highly concentrated beer industry has fragmented with the entry of new producers and products, including craft beer, malt-based seltzers, and flavored beers. But in 2020, beer "continued its annual volume declines, finishing the year down 2.8%" in IWSR data. Domestic beer fell 4.4% while imports grew 3.1%, to 21.8% of the category.[37] Beer wholesalers say the beer industry has lost $20 billion in sales through the COVID year. At one point, retailers seemed to see craft beer as the new "explorer" or "discovery" category, assuming a role long played by wine. That role may now be taken by RTDs.

DIRECT-TO-CONSUMER MARKET SEIZES THE MOMENT

Until the pandemic forced many tasting rooms to close, e-commerce represented a very small share of winery direct-to-consumer (DtC) sales.

According to the 2021 Sovos/ShipCompliant Direct to Consumer Wine Shipping Report (based on ShipCompliant-facilitated transactions), though DtC shipments surged by 27%, the average price per bottle shipped declined by 9.5%. During the period, wines costing less than $30 per bottle increased by 41.3%, as larger, value-oriented producers—usually sold in retail—developed their e-commerce businesses.

The growth in shipments was not sufficient to overcome the loss of other DtC sales, such as those in tasting rooms and wine club customer acquisition. ShipCompliant reported that total 2020 winery DtC sales fell below the 10% of total off-premises sales that had been recorded in previous years.[38]

Direct-to-Consumer Outlook

Sales patterns suggest that the DtC channel may be reverting to pre-pandemic sales patterns. Sovos/ShipCompliant reported that in May 2021 shipments were 25% higher than those in May 2019, but they fell below the comparable period in 2020. Volume has declined for wines costing less than $20 retail and risen for wines costing more than $50 retail. Some 2020 growth is being retained in the mid-price levels and among larger producers, particularly among better-known brands and those with the strongest social media, online marketing, and data analytics capabilities.[39]

WHOLESALERS AND DISTRIBUTORS RETHINK THEIR APPROACH

Wine wholesalers and distributors have not escaped the challenges facing restaurants and retailers, which have included:

- Narrowing of product selection
- Decline in the number of off-premises outlets
- Shift to virtual sales, marketing, and communication
- Increase in costs
- Reduction in staff—especially frontline sales staff focused on the on-premises sector

Although actively supporting major retailers in restocking their fast-moving labels—primarily in the $8-$20 segment—wholesalers have remained cautious overall about adding inventory.

The Wholesalers and Distributors Outlook

The wholesale tier is expected to consolidate and adjust operations as smaller and on-premises-focused wholesalers struggle in the new market. Wholesalers have discovered that much of their work can be conducted without long-distance travel, their prior complement of frontline salespeople, or with virtual tastings, training, and sales meetings—each of which changes the nature of account relationships and new product launches.

With the possible decline in on-premises locations and accounts, potential loss of smaller, weaker liquor stores and specialty stores, and pending assortment rationalization toward a narrower selection of wines in all channels—some weaker, less-well-capitalized and less-agile wholesalers have already closed. Others may yet fail or may merge with the major players, suggesting further concentration in the wholesale tier.

The pressures on the wholesale tier increase the incentives for wineries to upgrade their own branding, innovate their merchandising, and build their own customer following—reducing their expectations of wholesaler support. Wineries are also exploring alternatives to the conventional wholesale channel altogether.

THE CHANGING TASTES OF THE POST-COVID CONSUMER

The data suggests that the consumers who are most likely to be affected by the COVID experience are women with children, Millennials, and the older portion of Gen Z. Women continue to be key drivers of the wine market, especially for the home.[40] Wine consumption among Gen X women had been one of the bright signs in a struggling wine market, but it looks to be at least somewhat financially and price constrained for the next few years.

The U.S. wine industry has also been looking toward the Millennial generation as its next major market—and now it needs to recognize that Millennials and Gen Z appear to have very different tastes, as well as more financial constraints.

THE CHALLENGE CONTINUES FOR RESTORING WINE SALES GROWTH

A tumultuous 18 months has accelerated transformational changes in the business of wine that began more than a decade ago. The growth of e-commerce does not alter these trends but accentuates them. A multiyear slowdown in wine sales, the beverage's evident loss of appeal, and the excitement for other alcohol products demand attention and new thinking. The performance of wine during the pandemic shows that the factors that drove that slowdown do not appear to have abated. Continued loss of market share will only further discourage support for wine from not only wholesalers, but also retailers and restaurants, especially for smaller and weaker brands.

The American consumer's interest in wine was long driven by the excitement of discovery and exploration. Now everyone from bartenders to spirits purveyors and wine giants is moving in. Insurgents in wine have built a canned wine market that shows many new customers that wine can be casual, accessible, and affordable.

These are first steps, but ones to learn from—not only to reach new customers but to create new occasions for those customers to experience wine. Growing the U.S. wine market may mean diversifying products—wine-based seltzers, cocktails, and spritzers, as well as lighter, easier-drinking, lower-alcohol wines—and defining wine-consuming occasions in ways perhaps not yet imagined.

The U.S. wine industry also needs to expand its market, to reach beyond the affluent Baby Boomers who have defined American wine buyers for 30 years, toward new generations, and new ethnic, social, and economic communities. This means embracing modern messages and marketing, working to understand new cultural and demographic communities, and adjusting production and outreach to speak to them.

Finally, these repeated crises affecting the industry emphasize the importance for producers to maintain a sound financial position, with access to cash when under stress—a challenge in this capital- and inventory-intensive industry.

NOTES ON DATA IN THIS REPORT

Reporting whole-market data on wine sales requires the use of multiple sources: No single source reflects the entire wine market, including on-premises (brick and mortar retail and online), off-premises (all eating and drinking places, including restaurants, bars, and institutional locations—country clubs, corporate dining, medical and educational food service, etc.), and winery DtC (e-commerce, tasting rooms, wine clubs, and subscriptions).

Many reports on wine sales refer only to "Info-Scan" data: the data primarily collected from some segments of retail store checkout systems and reported by Nielsen (today Nielsen IQ) and IRI Worldwide. This data is derived from multiple channels, including grocery chains, convenience stores, club stores, and dollar stores, but includes few wine and spirits specialty stores. This data also does not include on-premises eating and drinking locations. Also, laws in 13 states do not permit wine to be sold in food or chain stores. Given the many excluded venues, Info-Scan data represents an estimated 30%-40% of total wine sales and is less representative of sales of more expensive wines and smaller producers.

The most representative data on total wine sales is generally considered to be wine wholesalers' data on sales to their trade accounts, called "depletion data." More than 80% of all U.S. wine is sold by U.S. wine producers and wine importers directly to wholesalers, who then sell to the trade. In 2018 the WSWA began releasing the SipSource[41] reports, aggregating depletion data from multiple members with other wine sales information.

This report makes frequent use of SipSource data, along with IRI, Nielsen reports, and DtC reports, combined with additional trade surveys, economic research and interviews, insights from Bank of the West, and multiple other available reports and analyses.

On-Premises Eating and Drinking Places Data

There is no organized data on operations and finances of the more than 1 million eating and drinking places in the U.S., beyond surveys done every five years or so by the National Restaurant Association, and some surveys produced by private research firms (e.g., Technomic, Datassential).

Winery Direct to Consumer Sales

ShipCompliant is the largest company that has emerged to help wineries handle DtC interstate-shipment compliance. Sovos/ShipCompliant compiles periodic reports on these transactions. But these reports account only for shipments facilitated by ShipCompliant. Thus, winery sales that are not shipped (e.g., carry-out, curbside pickup) are not included in the reports. Wines and Vines Analytics, which produces the ShipCompliant analysis, has in the past assumed such sales represent about 40% of total winery DtC sales.[42]

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